

<https://www.financial-planning.com/list/ask-an-advisor-why-are-alternative-assets-often-not-included-in-portfolios>

## **Ask an Advisor: Why are alternative assets often not included in portfolios?**

By Rob Burgess

October 28, 2024 3:14 PM

Welcome back to "Ask an Advisor," the advice column in which real financial professionals answer questions from real people. The topic can be anything in the world of finance, from retirement to taxes to wealth management — or even advice on advising.

Until recently, alternative investments have mainly been the province of the high net worth set. In the past few years, though, there has been a concerted effort to change that.

However, issues from lack of liquidity to extra taxation have caused many clients and advisors to steer clear.

This week, one advisor turned to his fellow professionals for insight as to this disparity:

*Dear advisors,*

*Why do most advisors not include alternative investments in their portfolios?*

*Sincerely,*

*Stoy Hall  
Founder and CEO  
Black Mammoth  
Ankeny, Iowa*

In response, advisors cited reasons for hesitancy around recommending alternative investments including being overly complicated, unfamiliar and illiquid and having higher fees, risks and opaque pricing structures.

Here are some of the responses we received to this week's question, edited lightly for clarity and length:

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### **There are plenty of other, less-complicated options out there**

Dale Hershman, principal at Sick Advisory Services in Boca Raton, Florida

Simply put, there is little evidence that alternative assets offer consistent outperformance over more simple, more liquid assets.

There have been time periods where alternatives have outperformed, but in terms of consistent long-term performance, alternatives could only be considered to "perhaps" outperform much more simple allocations. What is for sure is that alternatives are much more illiquid with much higher fees, leading to potential complications and drama for clients.

A lot of financial advisors are reluctant to allocate to an asset that only sometimes outperforms the market, but almost always represents more illiquidity risk and higher fees. Even for clients who seek non-correlated diversification in their portfolios, there are plenty of other, less-complicated options out there.

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### **High fees and the lack of liquidity can be a challenge**

David Flores Wilson, the managing partner of Sincerus Advisory in New York

The universe of alternative investments includes many different asset types and investment objectives, including private equity to achieve growth, private credit for income, multistrategy funds to achieve non-correlated returns, real estate to hedge inflation and many others. The myriad of strategies and options can be overwhelming for advisors who want to keep it simple.

Many alternative investment vehicles available to retail investors have several layers of fees embedded within them, so achieving an adequate return to compensate for the high fees and the lack of liquidity can be a challenge. Also, many alternative investment asset classes like private equity have high dispersion from the average return, so not having access to top-quartile funds can be an uphill battle in achieving attractive returns.

For many hedge funds, their use of leverage and frequent trading can lead to unattractive tax outcomes as gains may be subject to a high percent of ordinary income from short-term capital gains and additional unrelated business taxable income (UBTI) due to the use of debt.

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### **Alternatives can play an important role**

Daren Blonski, co-founder and managing principal of Sonoma Wealth Advisors in Sonoma, California

Alternatives can play an important role in a client's portfolio. Why advisors pitch what they pitch can be more nuanced. Unfortunately, the advisors' incentives are an important contributing factor and need to be understood by the clients. In a perfect world, the advisors' incentives are always aligned with the clients'. Secondly, advisors often pitch alternatives they are familiar with. Because alternatives are often complex, advisors don't generally talk about products that are not trained on. Third, advisors use alternatives that perhaps offer a negative

correlation to other pedestrian assets like commonly traded stocks and bonds.

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### **There are often unnecessary complexities**

Zack Gutches, founder and lead financial planner at True Riches Financial Planning in Aurora, Colorado

Alternative investments often come with additional risks that do not align with the values and goals for client portfolios that I manage. The nuances such as increased tax-reporting requirements, illiquidity, higher fees and enhanced lack of predictability in their returns and volatility often are unnecessary complexities relative to the potential utility they provide.

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### **When the next downturn hits, returns will fall**

John Blair, president and founder of Blair Capital Management in Norwalk, Connecticut

I do not invest my client's money in alternative investments for two primary reasons: One, alternative investments are very illiquid and from my own investment experience, that can be a terrible disadvantage. Second, I, as the fiduciary, have no control over how those alternative investments are managed.

What if projections don't materialize? Usually, the general partner simply continues to invest client money hoping that their initial projections come to fruition. But now, I, as the fiduciary, have to answer for the underperformance, and I have no control or ability to extract funds from the initial investment.

Yes, there are stories of strong returns, but when the next downturn hits, returns will fall and I project it will be very difficult to leave these investments and the perception of their superior returns will vanish.

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### **Ultimately, advisors bear responsibility for recommendations**

Jon McCardle, president of Summit Financial Group of Indiana in Lafayette, Indiana

While alternative investments offer attractive diversification potential, many financial advisors hesitate to incorporate them into client portfolios.

Many advisors operate under broker-dealer regulations or as affiliated Investment Advisor Representatives (IARs). These arrangements often limit the products and strategies advisors can recommend, potentially excluding certain alternative investments.

Historically, alternative investments were restricted to high net worth individuals due to the sophisticated investor rule. While these requirements have eased in recent years, allowing broader access, they still present a barrier for some investors.

Three primary factors discourage many advisors from recommending alternative investments:

**Complexity:** Alternative investments often involve intricate strategies and structures that require specialized knowledge.

**Risk profile:** These investments may introduce additional risks, such as liquidity constraints or heightened market sensitivity.

**Compensation structures:** The fee arrangements for alternative investments can be complex and may not align with traditional advisory models.

The alternative investment universe can include Real Estate Investment Trusts (REITs), private equity, mezzanine loans, inverse investments, sophisticated options strategies, cryptocurrencies and advisor liability. While these investments can offer significant benefits, they also carry unique risks. Ultimately, advisors bear responsibility for recommendations, which can make some hesitant to utilize these strategies.

Despite these challenges, the alternative investment space continues to evolve. More accessible products and improved education are gradually expanding the use of these strategies in retail investor portfolios. Financial advisors must carefully weigh the potential benefits of alternative investments against their complexity and risks when considering their role in client portfolios.

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### **Alternatives are challenging to evaluate and manage**

Stephan Shipe, founder and CEO of Scholar Financial Advising in Concord, North Carolina

Alternatives have higher complexity, lack of liquidity and often opaque pricing structures, which make them challenging to evaluate and manage, especially for advisors who are working on their own businesses.

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### **Clients shy away once they understand the issues**

Chris Wilbratte, founder and partner with Echelon Financial in Austin, Texas

Most clients focus on the potential growth of alternatives but are unaware of the illiquidity and investment risk, and don't have the expertise to perform due diligence on alternatives. Once they understand these issues, many change their

minds.